

**Joint communication of the Association of Global Custodians, Asia Focus Committee and ASIFMA**

11 July 2018

Ms. Pataravasee Suvarnsorn,  
Managing Director,  
Thailand Clearing House,  
62 Ratchadaphisek Road.  
The Stock Exchange Of Thailand Building,  
Khlong Toei, 10110  
Thailand.

**VIA HAND AND E-MAIL**

Dear Ms. Suvarnsorn,

**Thailand Clearing House – Pending Settlement**

We refer to the Thailand Clearing House's (TCH) circular to market participants entitled "Procedures for handling fail of securities deliver by using pending settlement", issued in October 2017.

We are very much encouraged by the TCH's quest to better manage fails in securities delivery in line with international standards—namely Principles for financial market infrastructures (PFMI). The Association of Global Custodians (AGC) <sup>[1]</sup> and the Asia Securities Industry & Financial Markets Association (ASIFMA) <sup>[2]</sup> works with regulators globally in the furtherance of the adoption of PFMI standards. This is why we are corresponding with you today.

There are elements of the procedures outlined in the above mentioned circular that in our opinion do not follow best practice.

<sup>[1]</sup> The Association of Global Custodians is an informal group of 12 financial institutions that provide securities safekeeping services and asset-servicing functions to primarily institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organizations around the globe. The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company. For more information visit [www.theagc.com](http://www.theagc.com)

<sup>[2]</sup> ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional and consulting firms, and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

The AGC has been supporting four of our member banks, which operate in a sub-custodian role in Bangkok, regarding their on-going discussions with the TCH, via their participation in the "Custody Club", on such best practices. We would like to offer the following comments in this regard:

**Background:**

1. On 6 November 2017 TCH introduced "Pending Settlement" with the aim of better managing failed deliveries and to be in line with international standards – namely Principles for Financial Market Infrastructure.
2. If the Delivering General Member has insufficient shares (after utilizing SBL), TCH will determine the Pending Receive parties who will not receive the securities based on its criteria for allocation of securities.
3. TCH will require the Delivering General Member to post collateral at 130% of the securities value due to the failed delivery of securities. TCH will keep such collateral on behalf of Pending Receive Party.
4. If the Delivering General Member fails to deliver shares within T+5, the pending trade will be settled via cash settlement instead of shares. TCH shall calculate the cash settlement value which will be paid by the Delivering General Member as compensation to the Pending Receive Party.

**Issues:**

1. Under the "pending settlement" mechanism, the pending receive party is required to pay 100% cash for its trade purchase while they will only receive a portion of the expected security position. International investors are concerned as the pending receive party (buyer) may be exposed to principal risk - even the excess amount paid over the securities received is being held by TCH since the cash payment is effected for securities that are not received.
2. According to the international standard: Principles for Financial Market Infrastructure, Principle 12: Exchange-of-value settlement systems, "an FMI that is an exchange-of-value settlement system should eliminate principal risk by ensuring that the final settlement of one obligation occurs if and only if the final settlement of the linked obligation also occurs, regardless of whether the FMI settles on a gross or net basis and when finality occurs."

Delivery versus payment (DVP) settlement links a securities transfer and a funds transfer in such a way as to ensure that delivery of securities occurs if, and only if, the corresponding payment is made.

Many investors in their agreements with their international brokers and Global Custodians (GS), prohibit partial settlement. This prohibition is passed on to any local brokers and sub-custodians (SC). To reduce exposure to principal risk, preference is where a GC/SC offer partial settlement, to only debit the purchase actual cost equivalent to the holdings the buyer will receive, instead of the full purchase amount which is the current practice.

From feedback received by AGC member banks, foreign investors have great difficulty in understanding the concept of pending settlement:

- firstly, a trade in Thailand can be classified as good, even if the counterparty has not delivered all shares, due to the way TCH allocates the shares at the clearing level; and
- secondly, the concept that the pending position can shift to another investor, because the pending receiver can use the pending receive position (PENR) in lieu of delivery obligation within TCH net clearing process.
- PENR positions only arise for matched trades.
- Given the current prioritization logic, the value of the trade is considered when allocating the PENR, so there would be a higher possibility for free receive trades to be allocated a PENR. In this case if the client is moving their securities free of payment between accounts, which can be due to change of service provider or securities loan under Thailand Clearing House net settlement process, the current PENR approach could result in the client getting paid cash compensation for securities the client already held with the outgoing global custodian and sub-custodian.
- With exchange traded funds (ETFs) issued in another country where Thailand equities are the underlying securities, ETF shares are created by an investor free delivering the underlying Thailand equities to the ETF and the ETF free delivering the ETF shares to the investor in the other country. ETF shares are redeemed by the ETF free delivering the underlying Thailand equities to the investor and the investor free delivering the underlying ETF shares in the other country. With Thailand equities being free delivered and free deliveries being prioritized for any PENR, there is a possibility that a PENR is allocated to this activity while the ETF shares are settled in the other country.

The current pending settlement modus operandi has also created some difficulties with Corporate Actions (CA). In the event that there is a PENR position on Record Date (RD), the position will not be entitled to CA benefits, rather TCH will help calculate the benefits compensation (115% of the total entitlement amount) and the defaulting broker will pay the investor by TCH's stipulated due date. However, there are four CA events, as tabled below, which TCH will not help calculate benefits compensation and investors will, therefore, need to bilaterally negotiate/agree on compensation with the defaulting party. This exposes investors to additional principal risk on top of the pending settlement process, since cash payment was already effected for the PENR position, but entitled CA benefits will not accrue in the normal way. Investors may have difficulties in securing entitlements in the case of the four CA events which they will need to bilaterally negotiate/agree on compensation with the defaulting party.

<b>TCH will calculate CA benefits compensation</b>	<b>TCH <u>will not</u> calculate CA benefits compensation</b>
XD (Excluding Dividend)	XW (Excluding Warrant)
XR (Excluding Right)	XS (Excluding Short Term Warrant)
XI (Excluding Interest)	XT (Excluding Transferable Subscription Right)
XN (Excluding Capital Return)	XM (Excluding Meeting)
XA (Excluding All)	
XE (Excluding Exercise Warrant)	
XP (Excluding Principal)	
XB (Excluding Other Benefits)	

As mentioned above, we do understand that there are ongoing discussions with fund managers, brokers and custodian banks to try and resolve matters. We further understand that some local market participants wish for the current pending settlement arrangements to continue. However, foreign institutional investors are very concerned with the lack of true DVP with such arrangements, the situation pertaining to partial settlements and the potential downstream impact that would result from cash settlement in the event shares cannot be located by SD+3.

The Thai market has made admirable progress over the last few years and the TCH and Stock Exchange of Thailand (SET) are to be congratulated on the recent successful implementation of T+2 settlement in the market. However, we earnestly request the TCH and SET to address the issues of DVP and partial settlements.

For the AGC's part, we will continue to support our four member banks in Thailand in working with the TCH to resolve matters.

Yours sincerely,



Robert Edwards, (as attorney in fact)  
For and on behalf of Karin Quek  
Chairman Asia Focus Committee,  
The Association of Global Custodians



Lyndon Chao, Managing Director,  
Head of Equities and Post Trade,  
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CC: Mr. Pakorn Peetathawatchai  
President, Stock Exchange of  
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CC: Mr. Rapee Sucharitakul,  
Secretary General, Securities and  
Exchange Commission of Thailand